



Cancellation of Debt Income – What You Need to Know

Legislative Authority

Internal Revenue Code (IRC)
section 61(a)(12):

Gross income includes
“income from discharge of
indebtedness.”



Cancellation of Recourse Debt and Gain/Loss on Disposition

- Discharge of recourse debt in a foreclosure: gain or loss on the disposition AND potential CODI. Amount realized: smaller of fair market value of the residence OR the outstanding debt immediately before the transfer.
- Discharge of recourse debt in a loan modification: no gain or loss, but CODI.



Cancellation of Nonrecourse Debt and Gain or Loss on Disposition

- Discharge of nonrecourse debt in a foreclosure: gain or loss on disposition, but no CODI. Amount realized is the full amount of the debt.
- Discharge of nonrecourse debt in a loan modification: CODI can arise. See Revenue Ruling 91-31; Revenue Ruling 92-99.



Exclusions – Tax-Deferred CODI under Section 108(a)

- Qualified farm indebtedness
- Qualified real property business indebtedness
- Discharge of certain indebtedness because of Midwestern disasters
- Certain businesses repurchasing their own debt

(added by section 1231 of ARRTA 2009)



Exclusions – Tax-Deferred CODI under Section 108(a) (cont'd)

- Bankruptcy
- Insolvency
- Qualified principal residence indebtedness added by Mortgage Forgiveness Debt Relief Act of 2007 for debt cancelled before January 1, 2013.



Insolvency Exclusion

- Exclusion only applies to the extent of insolvency.
- Insolvency calculation:
$$\begin{aligned} &\text{Total liabilities immediately before the discharge} \\ &- \text{FMV of total assets* before the discharge} \\ &= \text{Extent to which the taxpayer is insolvent} \end{aligned}$$

*Includes exempt assets (e.g., retirement account and interest in a pension plan).



The Mortgage Forgiveness Debt Relief Act of 2007 (MFDRA)

- Created a new exclusion under IRC sections 108(a)(1)(E) and 108(h) for discharged qualified principal residence indebtedness.
- Applies to indebtedness that is discharged on or after Jan. 1, 2007, and before Jan. 1, 2013.



The Mortgage Forgiveness Debt Relief Act of 2007 (MFDRA) (cont'd)

- Applies to acquisition indebtedness (as defined in IRC section 163(h)(3)(B).
- \$2 million limitation (\$1 million for MFS)
- “Principal residence” as defined in IRC section 121 (The 5-year look-back test is not part of the definition)



Acquisition Indebtedness Under MFDRA

IRC section 163(h)(3)(B) states: “Acquisition indebtedness is debt incurred in acquiring, constructing, or substantially improving the home and is secured by the home.”

Acquisition indebtedness:

- May include refinanced debt and the proceeds of a “home equity” loan used to substantially improve the home; but
- Does NOT include a “home equity” loan used to pay off credit cards, or purchase a car, pay medical bills, etc.



The Reporting Process Begins – Form 1099-C

IRC section 6050P states:

Certain lenders that cancel a debt of \$600 or more required to file Form 1099-C with the IRS and issue a copy to the borrower.



Taxpayer Reporting of Form 1099-C Income

- Taxpayers must report all Form 1099-C income on their returns.
- Taxpayers may be able to exclude part or all of the Form 1099-C income by completing Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*.

